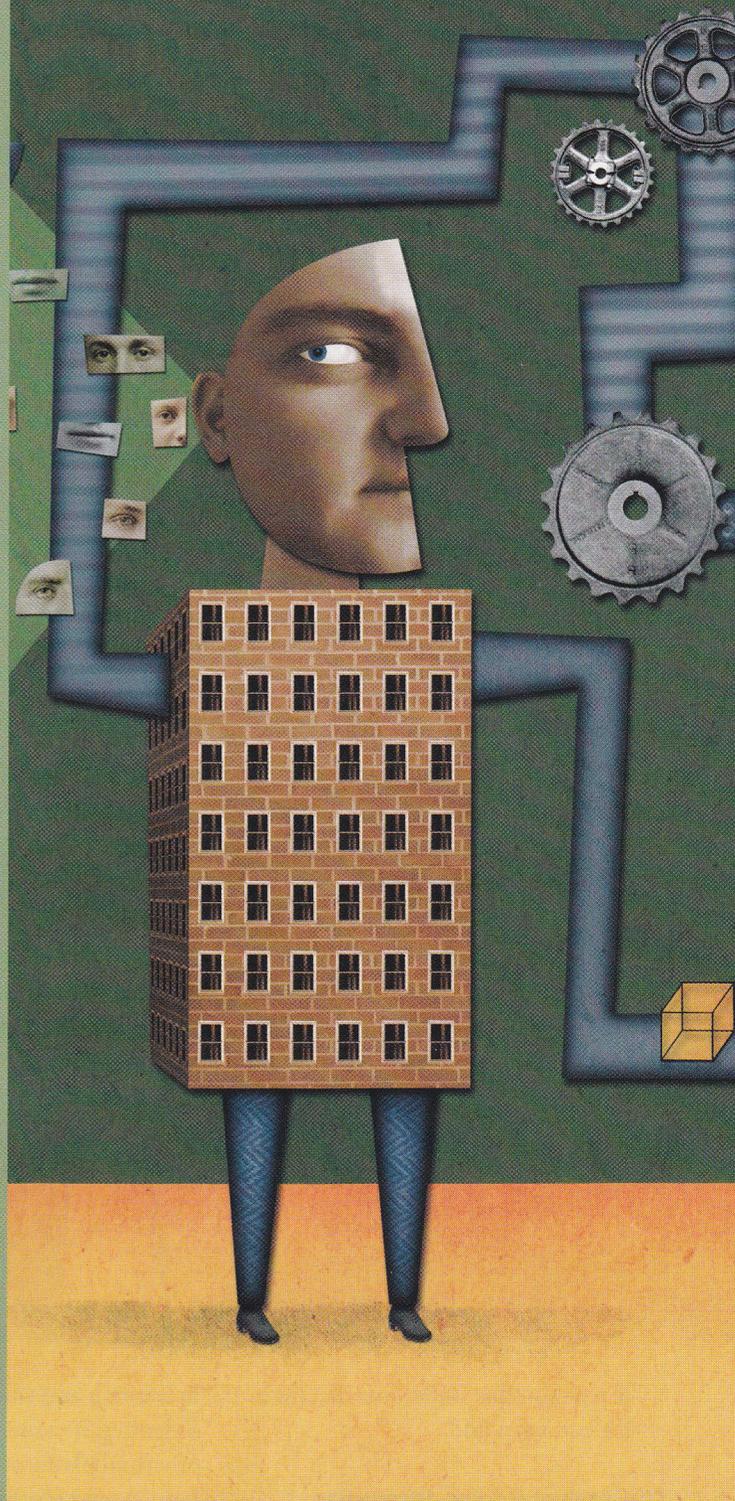


## BUSINESS STRATEGY

Some of the world's most influential businesses are catalysts—businesses that unleash the hidden value that comes from getting different groups of customers together on the same platform and allowing them to interact. Think Lloyd's of London, Hearst Newspapers, Microsoft—each owes its source of profits to a business model that makes it easy for buyers and sellers, readers and advertisers, developers and users to get together and do business.

If the lifeblood of a catalyst is to make it easier for multiple customer groups to come together and interact with one another, then their source of innovation is creating convenient and appealing platforms that attract and benefit both sides. Advances in technology and connectivity, coupled with the reduced cost of computing power, make this task easier than ever. It is fueling new kinds of catalysts that are reshaping—and disrupting—entire industries. Some of today's most successful companies, including Amazon, eBay and Google, wouldn't exist if they hadn't figured out the code to catalyst success.

Catalysts are emerging as today's new powerbrokers, and their strategies for success are as revolutionary as the innovative businesses they spawn. But it has required unlearning old ways of thinking to figure out what really makes catalysts tick and thrive. Nowhere is this departure from conventional business wisdom more evident than in the pricing arena where subsidized or even negative pricing schemes are critical for igniting the cataly-

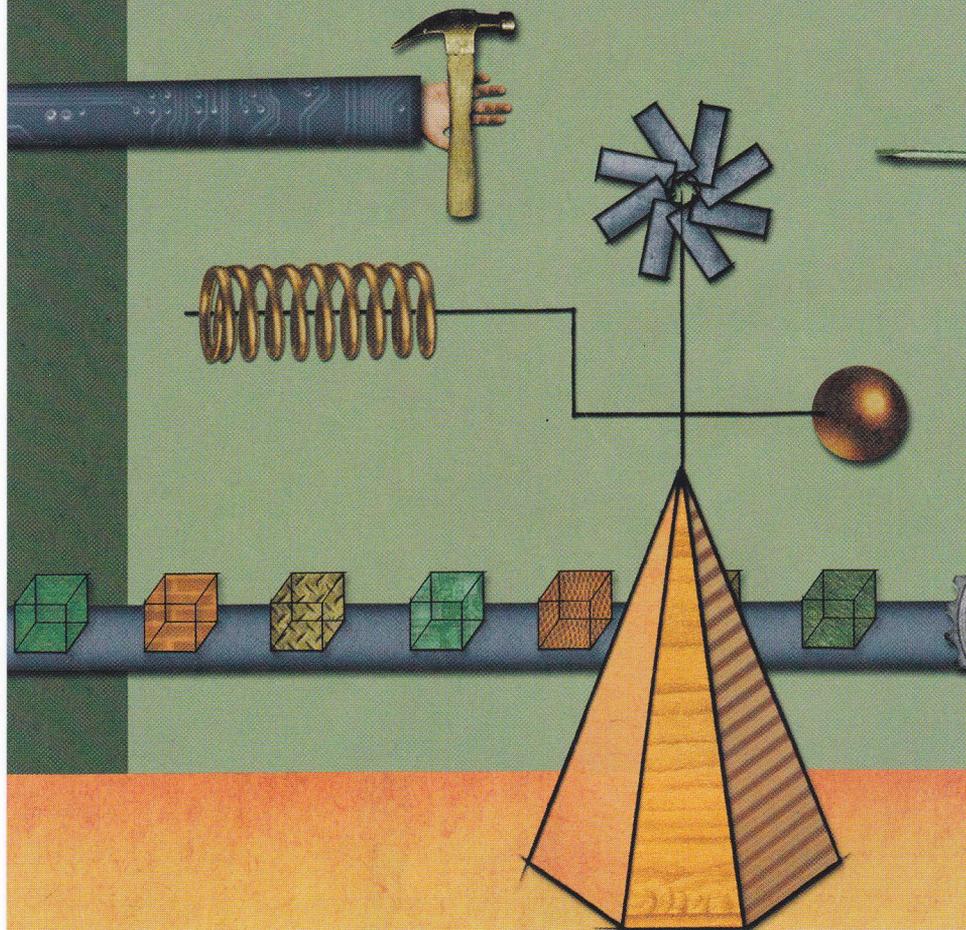


Pick  
your  
pricing

# How catalyst companies price for profit.

BY DAVID S. EVANS AND

RICHARD SCHMALENSEE



ic reaction that underpins success in the catalyst world.

## Catalyst Pricing Strategies

There are five critical strategic considerations that catalyst enterprises must make in order to effectively and profitably address the pricing dilemmas that face these unique business types.

### 1. Price for Access and Usage

Setting separate prices for access and usage means determining who,

how much and whether to charge in order to gain admission to a physical or virtual platform and use the platform. Access fees help attract enough of the right kind of customers on each side of the platform. Customers on one side may not be sure about how much value they will get from interacting with customers on the other side. If the “price is right,” they may try and see.

It is one reason why video-game console makers keep console prices

low. They want gamers to buy games—and lots of them—for which they receive royalties. Keeping admission fees high makes sense for other catalysts. It may help get the “right” customers to join the community and simultaneously discourage the “wrong” kind of customers.

Usage fees are important for guiding the catalytic reaction. Low ones encourage customers to intermingle, a strategy often adopted by at least one side in order to attract enough customers on the other. It’s the brilliance behind Google’s revenue strategy: Web searchers search for free but advertisers bid for prime spots to attract the attention of the billions of search requests Google handles each day.

### 2. Price to Balance the Demand

Catalysts that don’t get the right balance from the groups they serve simply won’t have a business. This balancing act—keeping both sides on board and interacting with each other—is also a major risk. Small deviations from the optimal prices can send a catalyst into an abyss. Raising prices to one group may reduce their participation so much that the other group also stops coming. This can lead to a death spiral.

Advertising-supported media have a particularly delicate tightrope to walk. Consumers who buy 50¢ newspapers, watch free television and listen to free radio—all because advertising subsidizes the cost to them—will tolerate only so much advertising before abandoning their “favorite” media for another less advertising-intensive option. Even satellite radio, with its promise of advertising-free format in exchange for a monthly subscription fee, has begun to introduce advertising on some of its channels in order to offset operating costs.

**3. Price to Grow Slowly—at First.** Many successful catalysts started small and expanded slowly by finding prices that capture and promote the forces that flow between members of the catalyst community. In fact, successful two-sided businesses often start with a

and probably one of the most critical decisions a catalyst makes.

In some cases, the degree to which each group needs the other is similar. The end result in these cases is a *symmetric pricing strategy* in which both contribute to operating profits. In oth-

customers is always a step away from a financial precipice, a lesson thousands of entrepreneurs learned the hard way during the dot-com bust. In what was almost mass hysteria, they seemed to take the old joke about selling each unit at a loss but making it up on volume as a strategic principle.

## Getting prices right is critical to building the community, getting members to interact and generating profits.

small number of customers from each side—small, that is, relative to their customers a year or five years later. But bringing the two sides together in this way can provide enough value for the participants to get a viable business going and ignite the market. Once other members of the community see this value, they join too, further increasing the value.

This is the essence of the Microsoft strategy. When the company debuted in the mid-1980s, it kept prices low—Microsoft Windows could be had for less than \$150—and gave free access to developers who wrote applications that made Windows more attractive to end users. Its user base grew from a few thousand in 1985 to more than 100 million in five years, even though users had more than 28,000 applications available to them.

### 4. Pay Customers to Belong (Sometimes)

Paying customers to belong means that catalysts make a decision to forgo profits from at least one significant group of customers but work to get enough customers on the other side “on board” so that they more than offset the losses. Deciding on the source of the catalyst’s operating profits is risky

er cases, one side will need the other side much more. The end result in this case is *asymmetric pricing*, in which one customer group gets a significant break. In that case, the less interested group needs a boost to join the community since it doesn’t value being part of it as much as the other group. With asymmetric pricing, the preponderance—and maybe even all—of the operating profit comes from the more interested group. Our research shows that asymmetric pricing is the norm for catalysts.

### 5. Price for Long-Term Profits

Pricing for long-term profits means evaluating whether the best prices are good enough to generate the return on capital needed to offset the significant investments required to create the virtual or physical platform that is the core of the catalyst enterprise.

Our observation is that many, if not most, catalysts find they have to just break even or lose money on one side of the business not just to break into the market, but forever. While rare for a single-sided business to decide to lose money on one of its products except for short-term “specials,” it is common for catalysts. Unfortunately, any business that gives things away to

### The Bottom Line

There is no universal formula available for all catalysts to use in their pricing decisions—but there is one universal truth: Getting prices right is critical to building the community, getting members to interact and generating profits. Often, the model that most catalyst enterprises create at the beginning is the model that they end up with at the end, for better or for worse, and there are even some common patterns across industries.

Video-game makers have universally settled on a pricing model that subsidizes the cost of the console in order to encourage gamers to buy games. For five decades, the payment industry has coalesced around a business model that has merchants subsidizing cardholders through the fees they pay to issuing banks. Gracis-Card has recently entered the payment industry with an entirely new model that lowers prices drastically to merchants and earns revenue through interest on receivables held by issuing banks. Time will tell whether this new model will attract enough merchants, cardholders and banks to give the incumbents cause for concern. ▲

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